

STATEMENT OF

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THE BANKRUPTCY CODE AND FINANCIAL INSTITUTION INSOLVENCIES

Thank you for inviting me to testify today. I am Donald Bernstein, co-chair of the Insolvency and Restructuring Group at Davis Polk & Wardwell LLP. I am on the Board of Editors of *Collier on Bankruptcy*, a Commissioner on the American Bankruptcy Institute's Commission on the Reform of Chapter 11 and a past Chair of the National Bankruptcy Conference. I am also a member of the Legal Advisory Panel that advises the Financial Stability Board regarding resolution issues, and, during the last few years, I have spent a significant portion of my time working on resolution plans for large financial firms under Section 165(d) of the Dodd-Frank Act -- commonly known as Living Wills. I am here today in my individual capacity, and the views I express are my own, and not those of Davis Polk, any client or any organization with which I am affiliated.

I have been asked how financial firms can fail and be resolved in a rapid and orderly way in proceedings under the Bankruptcy Code. This requires consideration not only of the Bankruptcy Code, but also the insolvency and resolution laws applicable to domestic banks (the Federal Deposit Insurance Act), domestic broker-dealers (the Securities Investor Protection Act), and, in the case of non-U.S. affiliates of U.S.-based financial firms, foreign insolvency and resolution laws (like special administration in the United Kingdom).

As a prelude, I will make a few observations about the Lehman Brothers bankruptcy and its implications for the bankruptcy resolution of other large financial firms. I will also provide an overview of the single-point-of-entry resolution strategy being developed by the FDIC under Title II of the Dodd-Frank Act's Orderly Liquidation Authority or OLA. I will then turn to how firms can be resolved in an orderly way under

current bankruptcy law if – unlike Lehman Brothers – they do appropriate advance planning. Finally, I will identify several changes to the Bankruptcy Code that would facilitate the resolution of financial firms in bankruptcy.

Lehman Brothers and Contagious Panic

The unplanned failure of Lehman Brothers, the largest failure of a U.S. financial firm during the financial crisis, had a very disruptive effect on the financial stability of the United States, even though the losses ultimately suffered by creditors in the Lehman bankruptcy were not themselves catastrophic. There is no doubt that Lehman's bankruptcy exacerbated a crisis of confidence in the financial services sector and was a major factor in the subsequent decisions to provide federal government support of a variety of kinds to the financial system during the financial crisis.

Financial firms, both large and small, are vulnerable to a loss of confidence because they engage in the economically crucial business of maturity transformation. They incur short-term liabilities (for example, liabilities to depositors) to permit them to invest in long-term assets (such as mortgages and corporate loans). When short-term creditors lose confidence in a financial firm, they run for fear that the firm will be unable to pay their claims. Such a run strains the financial firm's liquidity resources and, if prolonged and intense, ultimately can force the firm to sell its assets to raise cash, regardless of the condition of the financial markets at the time. Selling into depressed markets can lead to further losses, turning a fear of insolvency into reality. Such fire-sales can also depress market prices, which reduces the mark-to-market value of similar assets

on the books of other firms.¹ This contagious downward spiral resulting from a loss of confidence in financial firms has been called contagious panic in a recent report of the Bipartisan Policy Center entitled *Too Big to Fail: The Path to a Solution* (the BPC Report).²

Lehman's unplanned failure unfolded in just this way. A run led to a liquidity crisis as Lehman struggled to liquify assets to meet the claims of short-term creditors, the liquidity crisis led to bankruptcy, which in turn led to wholesale close-outs of open trades, the selling of collateral into distressed markets and ultimately the sale of Lehman's businesses and assets at fire-sale prices. This cycle in turn led to the fear in the markets that other firms might suffer the same fate – contagious panic.

The goal of an effective strategy for resolving distressed financial firms, whether large or small, should be to avoid the abrupt unraveling of the firms and the crucial maturity transformation service they offer through fire sales into distressed markets. Distressed firms must be able to meet sudden liquidity demands without being forced to abruptly sell their assets into the markets at distressed prices. Over the longer term, they must be able to fail and either be recapitalized or be wound down in an orderly manner –

¹ See, e.g., Andrei Shleifer & Robert W. Vishny, *Fire Sales in Finance and Microeconomics*, 25 Journal of Economic Perspectives 29 (2011). Fire sales also impose deadweight losses on the wider economy. *Id.*

² John F. Bovenzi, Randall D. Guynn & Thomas H. Jackson, *Too Big to Fail: The Path to a Solution*, A Report of the Failure Resolution Task Force of the Financial Regulatory Reform Initiative of the Bipartisan Policy Center, p. 1 (May 2013). See also Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, *Toward Building a More Effective Resolution Regime: Progress and Challenges*, Remarks at the Federal Reserve Board and Federal Reserve Bank of Richmond Conference, Planning for the Orderly Resolution of a Globally Systemically Important Bank (Washington, D.C., Oct. 18, 2013); Hal S. Scott, *Interconnectedness and Contagion* (Nov. 20, 2012); Randall D. Guynn, *Are Bailouts Inevitable?*, 29 Yale Journal on Regulation 121 (2012).

in either case with adverse consequences for shareholders, debt holders and management. This allows them to obtain appropriate values for their assets, avoids market panic, and does not involve the rapid and disorderly liquidation of their balance sheets.

Since 2008, the resiliency of the financial system has increased substantially, with enhanced capital and liquidity requirements as well as enhanced supervision of non-bank financial companies. As a result, the ability of the firms to recover from financial shocks has increased and the probability of failure has been significantly reduced. In addition, the ability to implement resolution strategies that avoid the abrupt unraveling of the firms' balance sheets has increased.

One Approach to Addressing Contagious Panic: The FDIC's Single-point-of-entry Recapitalization Strategy

In 2008, regulators attempting to stem contagious panic and resolve distressed financial institutions without fire-sales of assets and the unraveling of maturity transformation had a very limited set of tools, and the inadequacy of those tools and the lack of pre-failure planning led to the investment of taxpayer funds to support the financial system. Though all large financial institutions repaid those investments with interest, there was wide recognition that other tools were needed to deal with the failure of financial firms. Title II of the Dodd-Frank Act (Orderly Liquidation Authority or OLA), provides a valuable additional tool. Regulators and commentators, including the BPC Report, have increasingly come to favor the single-point-of-entry approach to addressing the failure of financial firms proposed by the Federal Deposit Insurance

Corporation (the FDIC) under OLA.³ In its purest form, single-point-of-entry involves commencing resolution proceedings only with respect to the financial firm's top-level holding company, with all losses being borne by shareholders and creditors of that entity and not by taxpayers. Operating entities, like the firm's banking or broker-dealer subsidiaries, would not be placed in insolvency or resolution proceedings, but instead would be recapitalized using assets of the holding company and would continue as subsidiaries of a newly created debt-free bridge holding company. Instead of being liquidated, the firm would be restructured and recapitalized, leaving behind the holding company's creditors and shareholders in the OLA receivership, and creating a viable recapitalized firm the value of which would be preserved for the holding company's stakeholders without requiring a prolonged resolution process for the operating entities.

By recapitalizing the firm's operating subsidiaries with holding company assets, the single-point-of-entry approach preserves the value of those operating businesses and pushes the firm's operating losses up to the old holding company to be absorbed by the holding company's shareholders and creditors. The holding company's stakeholders nevertheless benefit from the strategy because liquidation of the firm's valuable operating

³ See, e.g., Federal Deposit Insurance Corporation & Bank of England, Joint Paper, *Resolving Globally Active, Systemically Important, Financial Institutions* (Dec. 10, 2012) (jointly proposing the single-point-of-entry approach); Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, *Toward Building a More Effective Resolution Regime: Progress and Challenges*, Remarks at the Federal Reserve Board and Federal Reserve Bank of Richmond Conference, Planning for the Orderly Resolution of a Globally Systemically Important Bank (Washington, D.C., Oct. 18, 2013) ("The single-point-of-entry approach offers the best potential for the orderly resolution of a systemic financial firm..."); William Dudley, President and Chief Executive Officer, Federal Reserve Bank of New York, Remarks at the Federal Reserve Board and Federal Reserve Bank of Richmond Conference, Planning for the Orderly Resolution of a Globally Systemically Important Bank, P. 1 (Washington, D.C., Oct. 18, 2013) ("I very much endorse the single-point-of-entry framework for resolution as proposed by the Federal Deposit Insurance Corporation (FDIC)."). For step-by-step diagrams illustrating the FDIC's single-point-of-entry resolution strategy, see BPC Report, pp. 23-32.

businesses and assets at fire-sale prices is avoided and the going concern value of the operating subsidiaries is preserved. This value ultimately is available for distribution to the stakeholders in the receivership.

The United States is fortunate that large U.S. financial firms rely on a holding company structure, where significant amounts of long-term unsecured debt issued by the parent holding company are structurally subordinated to deposits and other operating liabilities of financial subsidiaries. This structure creates an additional layer of loss absorbency at the holding company level, providing the ability, as the FDIC suggests, to keep systemically critical operating subsidiaries out of resolution proceedings despite the failure of the parent. Other countries are adopting similar recapitalization approaches as they pursue local and regional law reform, though in countries that have a unitary bank model (where there are no holding companies), the recapitalizations must be accomplished through bailing in (conversion to equity) of operating entity debt.⁴

As I have already noted, large financial firms have undergone substantial changes since 2008 that facilitate the implementation of the single-point-of-entry strategy and improve their resiliency, including a substantial increase in loss-absorbing capital and

⁴ See, e.g., Martin J. Gruenberg, Chairman, FDIC, Remarks at the Volcker Alliance Program, Washington, D.C. (Oct. 13, 2013) (describing endorsement of single-point-of-entry resolution model by the U.K., Germany and Switzerland as the preferred strategy for resolving global financial institutions, and progress being made in Europe, China, Japan and elsewhere); European Commission, Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms (2012), including the power to bail-in debt (convert it to equity) through a single-point-of-entry resolution strategy; Paul Tucker, Deputy Governor for Financial Stability at the Bank of England, *Solving too big to fail – where do things stand on resolution?*, Remarks at the Institute of International Finance 2013 Annual Membership meeting, Washington, D.C. (Oct. 12, 2013) (describing the single-point-of-entry resolution strategy as workable now in the United States and predicting it will be workable soon in the U.K. and Europe generally); Federal Deposit Insurance Corporation & Bank of England, Joint Paper, *Resolving Globally Active, Systemically Important, Financial Institutions* (Dec. 10, 2012).

balance sheet liquidity to meet regulatory requirements and risk management needs,⁵ the de-risking of the balance sheets of U.S. financial firms and capital restructuring to address anticipated requirements for minimum amounts of loss absorbing debt and assets in the holding companies of financial firms.⁶

⁵ See Federal Reserve and OCC, Regulatory Capital Rules, 78 Fed. Reg. 62, 018 (Oct. 11, 2013) (to be codified at 12 C.F.R. Pts. 3, 5, 6, 165, 167, 208, 217, and 225); FDIC, Regulatory Capital Rules, 78 Fed. Reg. 55, 340 (Sept 10, 2013) (to be codified at 12.C.F.R. pts. 303, 308, 324, 327, 333, 337, 347, 349, 360, 362, 363, 364, 365, 390, and 391); Federal Reserve, OCC and FDIC, Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring (Proposed Rule), 78 Fed. Reg. 71, 818 (Nov. 29, 2013). According to the Federal Reserve, the largest U.S. bank holding companies have increased their common equity to more than twice the amount they had during the financial crisis of 2008. Specifically, the weighted tier 1 common equity ratio, which is the ratio of common equity to risk-weighted assets, of the 18 bank holding companies that participated in the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) has more than doubled from 5.6% at the end of 2008 to 11.3% in the fourth quarter of 2012, reflecting an increase in common equity from \$393 billion to \$792 billion during the same period. See Federal Reserve, Press Release – Federal Reserve Announces Results of Comprehensive Capital Analysis and Review (CCAR) (Mar. 14, 2013), available at <http://www.federalreserve.gov/newsevents/press/bcreg/20130314a.htm>. The results of the Federal Reserve's 2013 Dodd-Frank and CCAR stress tests show that the largest U.S. bank holding companies have enough common equity to absorb all of their projected losses under the Federal Reserve's severely adverse stress scenario and still have enough common equity left to exceed the minimum risk-based and leverage capital requirements. See Federal Reserve, Comprehensive Capital Analysis and Review 2013: Assessment Framework and Results (Mar. 14, 2013), available at <http://www.federalreserve.gov/newsevents/press/bcreg/ccar-2013-results-20130314.pdf>. Besides a significant increase in levels of loss-absorbing capital, U.S. banks have also substantially improved their liquidity profiles. For example, U.S. banks' holdings of cash and high-quality liquid securities have more than doubled since the end of 2007 and now total more than \$2.5 trillion. See Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, Stress Testing Banks: What Have We Learned? (Apr. 8, 2013), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20130408a.pdf>.

⁶ See Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, *Toward Building a More Effective Resolution Regime: Progress and Challenges*, Remarks at the Federal Reserve Board and Federal Reserve Bank of Richmond Conference, Planning for the Orderly Resolution of a Globally Systemically Important Bank (Washington, D.C., Oct. 18, 2013) (announcing that the Federal Reserve expects to propose minimum long-term debt and eligible assets requirements applicable at the bank holding company level for the largest U.S. banking groups within the next few months in order to ensure they have sufficient loss-absorbing resources to facilitate a single-point-of-entry resolution). See also *Progress and Next Steps Towards Ending "Too-Big-To-Fail" (TBTF)*, Report of the Financial Stability Board to the G-20 (Sep. 2, 2013) (announcing that the Financial Stability Board is developing minimum gone-concern loss-absorbing capacity requirements to ensure that global and domestic systemically important financial institutions have enough loss-absorbing capacity in the form of equity, long-term debt and assets to recapitalize the institutions without the need for taxpayer capital in the event of severe financial distress). See also, Morgan Stanley Research North America, *Large and Midcap Banks, OLA: More Debt Sooner?* (Dec. 13, 2012); Goldman Sachs Research, *Loss Absorbency in Banks* (Dec. 2012); J.P. Morgan North America Credit Research, *Tarullo Speech Increases Momentum for Debt Buffers* (Dec. 6, 2012).

Moreover, because of initiatives at the multinational level, including those of the Financial Stability Board and the crisis management groups organized among key regulators of individual firms, there is increasing alignment among national regulatory authorities regarding the benefits of recapitalization and bail-in approaches to dealing with failure.⁷ A single-point-of-entry recapitalization, for example, protects host-country interests by making resolution proceedings for host-country operations unnecessary. Since the operations of the largest financial firms are highly concentrated in a few jurisdictions, like the US and the UK,⁸ coordination and alignment among the relevant authorities can readily occur if appropriate advance planning among regulatory authorities can be done. Key to these efforts is the fact that recapitalization and bail-in strategies allow the firms to continue their business and meet their operating obligations in the ordinary course in both home and host countries. As a result, local regulators do not feel compelled to take precipitous actions that can hinder the resolution of the overall group.

⁷ See, e.g., Financial Stability Board, *Key Attributes for Effective Resolution Regimes of Financial Institutions* (Oct. 2011) (endorsing recapitalization (bail-in) within resolution strategies and advocating the creation of legal tools to effect such strategies); Federal Deposit Insurance Corporation & Bank of England, Joint Paper, *Resolving Globally Active, Systemically Important, Financial Institutions* (Dec. 10, 2012) (endorsing and advocating single-point-of-entry resolution strategies for systemically important financial institutions); *Progress and Next Steps Towards Ending “Too-Big-To-Fail” (TBTF)*, Report of the Financial Stability Board to the G-20 (Sep. 2, 2013) (endorsing single-point-of-entry and multiple-point-of-entry resolution strategies and announcing plans for minimum gone-concern loss-absorbing capacity requirements to ensure the feasibility of such strategies).

⁸ See FDIC Presentation to the FDIC Systemic Resolution Advisory Committee Meeting, Panel on International Resolution Strategy (Dec. 10, 2012) (over 90% of the total reported foreign activity for the top seven U.S. SIFs is located in three foreign jurisdictions, with the UK having the largest footprint). Video available at http://www.vodium.com/MediapodLibrary/index.asp?library=pn100472_fdic_SRAC. Presentation slides from the meeting are available at http://www.fdic.gov/about/srac/2012/2012-12-10_international-resolution-strategy.pdf.

Orderly Liquidation Authority includes special tools that facilitate implementation of a single-point-of-entry resolution strategy. Among the most important of these tools are the following:

- *The Bridge Holding Company Tool.* OLA provides a very clear path to creating and transferring the stock of recapitalized operating subsidiaries to a new bridge holding company, leaving holding company debts and equity behind in the FDIC receivership. The Bridge Holding Company Tool allows the operating businesses to be quickly and clearly separated from the failed holding company, and also simplifies the governance of the operating subsidiaries, allowing them to maximize their value in the most efficient manner possible.⁹
- *The Liquidity Support Tool.* OLA includes the Orderly Liquidation Fund (OLF),¹⁰ which is ultimately underwritten by private sector financial firms¹¹ and provides fully-secured interim liquidity support if necessary to help stabilize the recapitalized financial firm and avoid any fire-sale of the firm's assets.
- *The Financial Contract Preservation Tool.* OLA includes special provisions to permit the preservation of financial contracts by briefly

⁹ Section 210(o) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), 12 U.S.C. § 5390(o).

¹⁰ Section 210(n) of the Dodd-Frank Act, 12 U.S.C. § 5390(n).

¹¹ Section 210(o) of the Dodd-Frank Act, 12 U.S.C. § 5390(o), providing for the imposition of risk-based assessments on large financial firms to cover any losses of the OLF.

staying close outs due to bankruptcy defaults,¹² or, in the case of contracts of subsidiaries, invalidating cross-defaults arising out of the failure of the holding company, so such contracts can be assumed and preserved.¹³

Market participants increasingly recognize the viability of the single-point-of-entry approach to resolution of financial firms. A few weeks ago, for example, Moody's Investor Service announced that, on the strength of the progress being made on single-point-of-entry resolution, the two-notch uplift provided to ratings of the debt of the largest bank holding companies to account for the possibility of government support would be eliminated.¹⁴

An Alternative Approach: Pre-Planned Resolution of Financial Firms in Bankruptcy

While single-point-of-entry under OLA offers a clear path to the orderly resolution of distressed U.S. financial firms, more traditional bankruptcy proceedings provide another path that, despite the Lehman Brothers experience, can be utilized with appropriate pre-planning. The Dodd-Frank Act makes clear that the use of Orderly Liquidation Authority is to be limited to situations where bankruptcy is not a viable resolution strategy,¹⁵ and the FDIC has announced that it supports the idea that

¹² Section 210(c)(8), (9), (10) of the Dodd-Frank Act, 12 U.S.C. § 5390(c)(8), (9), (10).

¹³ Section 210(c)(16) of the Dodd-Frank Act, 12 U.S.C. § 5390(c)(16).

¹⁴ Moody's Investors Service, Rating Action: Moody's Concludes Review of Eight Large U.S. Banks (Nov. 19, 2013).

¹⁵ Section 203(b) of the Dodd-Frank Act provides in relevant part that the Orderly Liquidation Authority of Title II of the Dodd-Frank Act may not be legally invoked unless the Secretary of the Treasury determines that "the failure of the financial company and its resolution under otherwise applicable Federal or State law [e.g., the Bankruptcy Code] would have serious adverse effects on financial stability in the United States" and "any action under section 204 [of the Dodd-Frank Act] would avoid or mitigate such adverse effects"

bankruptcy, not OLA, should be the presumptive resolution procedure.¹⁶ The Bankruptcy Code provides transparency, the opportunity for affected parties to receive notice and be heard in court, and ex-ante judicial review prior to major actions. Bankruptcy is also well-established and well-understood by market participants, even though banks, insurance companies and securities firms have long been excluded from ordinary bankruptcy proceedings. Thus, it is not surprising that Dodd-Frank provided that bankruptcy should be used to resolve the failed holding company of a financial firm wherever possible.

The goals of a bankruptcy resolution should be to assure market participants that the liquidity needs of the distressed firm can be satisfied and fire sales can be minimized, that the firm's critical operations, including intercompany support services, will be continued or exited in an orderly way, and that the firm's losses will be imposed on shareholders and private creditors, such as long-term debt holders of the firm's holding company, while obligations of the operating subsidiaries (such as deposit liabilities and other money-equivalent liabilities) are paid in full.

Of course, multi-entity financial firms will be resolved not only under the Bankruptcy Code, but also their different operating subsidiaries will be subject to multiple insolvency regimes, both in the United States and in other countries. There is no

¹⁶ See Remarks by Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation, on Implementation of the Dodd-Frank Act before the Volcker Alliance Program (October 13, 2013) *available at* <http://www.fdic.gov/news/news/speeches/spoct1313.html>; See also Statement of Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation on Implementation of the Dodd-Frank Act before the Committee on Banking, Housing and Urban Affairs, United States Senate (December 6, 2011) ("If the firms are successful in their resolution planning, then the OLA would only be used in the rare instance where resolution under the Bankruptcy Code would have serious adverse effects on U.S. financial stability"), *available at* <http://www.fdic.gov/news/news/speeches/chairman/spdec0611.html>.

question that the multiplicity of insolvency regimes and the related multiplicity of controlling parties and conflicting interests greatly complicated the Lehman Brothers bankruptcy proceedings.¹⁷

The simplest way to avoid competing resolution proceedings would be to have a clear path to a single-point-of-entry approach to financial firm insolvencies under the Bankruptcy Code. However, the absence of an express Bridge Holding Company Tool, a Liquidity Stabilization Tool and a Financial Contract Preservation Tool in the Bankruptcy Code makes it harder for financial firms to implement a pure single-point-of-entry approach in bankruptcy. As a result, under current law, resolution plans typically adopt hybrid approaches, in which some operating businesses and entities continue and are sold or recapitalized, while others are allowed to wind-down in an orderly way.

First, the resolution plans typically identify those material operating entities or businesses that, because of their capital structure and the nature of their businesses, are unlikely to suffer material losses and can be continued without resolution proceedings if their liquidity needs are met. The plans then specify how the liquidity needs of such entities will be met, and provide for their sale, either in advance of or immediately after the firm's failure, or their continuation along with other subsidiaries that are recapitalized as described below. The sale of such entities or their assets would be analogous to the

¹⁷ More than 100 different insolvency proceedings were ultimately commenced for Lehman Brothers legal entities. *See* Presentation by Harvey R. Miller and Maurice Horwitz, *available at* http://www.stern.nyu.edu/cons/groups/content/documents/webasset/con_041232.pdf. This led to complex interaffiliate disputes between entities that once operated together as a global business, but were now being administered under different resolution proceedings as separate legal entities.

speedy sales that took place in the Lehman case, but would be more orderly and value-preserving because they would be pre-planned to achieve these objectives.

Second, the resolution plans typically identify those entities in the financial firm's group that may suffer losses but can be recapitalized, provided with liquidity and continue in business for the benefit of stakeholders, just as they would be in a single-point-of-entry resolution under Orderly Liquidation Authority.¹⁸ OLA's Bridge Holding Company Tool can be replicated under the Bankruptcy Code using section 363 of the Bankruptcy Code to authorize a transfer of the recapitalized subsidiaries to a debt-free holding company that is set up in advance or at the time of failure, perhaps owned by a trust for the benefit of creditors and other stakeholders left behind in the bankruptcy case. The new holding company would be separated from the risks of the bankruptcy process and once its business was stabilized, it could be sold in one or more private or public transactions, or its shares could be distributed to creditors of the old holding company under a conventional chapter 11 plan of reorganization. The trust could be structured to replicate the governance advantages offered by the Bridge Holding Company Tool, with appropriate modifications approved by the Bankruptcy Court.

Finally, for any entities that cannot be sold or recapitalized, and as a back-up strategy even for those that can be, the resolution plans typically provide for such entities

¹⁸ Among other things, any insured depository institution that is fully recapitalized in a single-point-of-entry resolution would have access to secured liquidity from the Federal Reserve's Discount Window. In addition, despite the absence of the Financial Contract Preservation Tool in the Bankruptcy Code, it may be possible to recapitalize entities that have portfolios of financial contracts. If, for example, some or all of the financial contracts housed in a bank or broker-dealer subsidiary are not guaranteed by the parent or cross-defaulted by the parent company's bankruptcy, or depending on the number of contracts that contain such cross-default provisions, losses, if any, on financial contracts could simply be absorbed by the recapitalized entities.

to be wound down in an orderly way that avoids asset fire sales. These orderly wind-downs require advance planning. The impact of different insolvency regimes and the reactions of regulators, customers, counterparties, financial market utilities and others need to be anticipated and addressed in the resolution plan, and the plan needs to provide for the management of liquidity needs, the orderly transition of systemically critical operations to other providers, the maintenance of the continuity of shared services and technology during the wind-down, and the orderly distribution of customer assets and property.

One of the characteristics that facilitates an orderly wind down is that the firms' enhanced capital and liquidity levels allow them to sustain a pre-failure client-driven run so that significant parts of their balance sheets can be wound down in an orderly way prior to or immediately after failure. Prime brokerage accounts are a good example of this. In 2008, one of the factors that precipitated the liquidity crisis at Lehman was a race to the exits by prime brokerage customers, requiring rapid liquidation of Lehman's assets to meet the demands of exiting customers.¹⁹ Not only was the liquidity strain of meeting the run too much for the firm; neither the firm nor its customers were in a position to quickly move the accounts even if there had been sufficient liquidity to meet the run. This

¹⁹ See, e.g., Gary B. Gorton & Andrew Metrick, *Securitized Banking and the Run on Repo*, 104 *Journal of Financial Economics* 425-51 (2012); Gary B. Gorton, *Slapped by the Invisible Hand: The Panic of 2007* (2010); Council on Foreign Relations Squam Lake Working Group on Financial Regulation, *Working Paper: Prime Brokers and Derivatives Dealers* (April 2010) ("[Prime brokerage asset] runs, together with runs by short-term creditors, precipitated Bear Stearns' and Lehman's demise"), available at <http://www.cfr.org/thinktank/cgs/squamlakepapers.html>. See also Darrel Duffie, *Bank for International Settlements Working Papers*, No. 301: *The Failure Mechanics of Dealer Banks*, Section 4.3 (March 2010), available at <http://www.bis.org/publ/work301.pdf>; Remarks of Daniel K. Tarullo, Governor, Federal Reserve Board, *Americans for Financial Reform and Economic Policy Institute Conference*, Washington, D.C. (Nov. 22, 2013), available at <http://www.federalreserve.gov/newsevents/speech/tarullo20131122a.htm>.

is, however, a contingency that can be planned for as part of resolution planning. Balance sheet liquidity can be used to meet the run, and a virtually complete orderly pre-failure transition of the firms' prime brokerage customers to other financial intermediaries can be accomplished in a matter of days.²⁰ Customers would be protected, systemic risk from the possible suspension of access to prime brokerage accounts in bankruptcy would be eliminated, and the complexity and systemic impact of any subsequent bankruptcy would be substantially reduced.

Financial firms can take other steps, either well in advance of or immediately prior to failure, to reduce the difficulty and complexity of bankruptcy wind-downs. These steps might include, among many others:

- pre-positioning employees and service assets within the group and documenting service relationships to maintain continuity of intercompany support services in wind-down;
- licensing or repositioning technology and related infrastructure within the corporate group to assure ongoing availability to all relevant entities after failure;
- replication or repositioning of data resources to assure their availability to all relevant entities after failure;
- using available liquidity to return collateral to the firm's balance sheet prior to failure to avoid it being dumped on the market post-failure;

²⁰ The now prevalent market practice of prime brokerage customers of maintaining accounts with multiple prime brokers will also facilitate rapid account transfers.

- positioning liquidity where needed for purposes of facilitating an orderly wind-down of wind-down entities; and
- advance discussions with relevant host-country authorities regarding how host-country interests will be protected and how insolvencies in different jurisdictions can be coordinated to minimize systemic risk.

Resolution plans under current bankruptcy law thus rely on a combination of approaches: revising current operating practices to facilitate resolution should it become necessary, anticipating a client-driven reduction in the firm's balance sheet prior to resolution supported by the firms' enhanced capital and liquidity positions, pre-planning of the marketing and sale of some the firm's businesses, pre-planning the recapitalization and continuation of other entities and businesses, and detailed pre-planning of the wind-down of still others. Hybrid approaches of this type can be very robust with appropriately detailed resolution planning. They also can benefit from advance consultation with and education of regulators, market participants and those who administer the bankruptcy system in each relevant jurisdiction, as well as thoughtful changes in market practice to facilitate resolution.²¹

Possible Modifications to Existing Bankruptcy Law

All of the above being said, the benefits of whole-firm recapitalization of the kind represented by the FDIC's single-point-of-entry approach cannot be denied. Because of their complexity, hybrid approaches entail execution risk and the likelihood of larger

²¹ For example, several regulators recently sent a letter to the International Swaps and Derivatives Association ("ISDA") urging ISDA to revise its standard forms to eliminate cross-defaults arising from the resolution of a parent holding company in a single-point-of-entry resolution strategy. Joint Letter to ISDA dated Nov. 5, 2013 from the Bank of England, the Bundesanstalt für Finanzdienstleistungsaufsicht, the Federal Deposit Insurance Corporation and the Swiss Financial Market Supervisory Authority.

losses for holding company creditors and shareholders than a pure single-point-of-entry approach. Accordingly, reforms to the Bankruptcy Code to add tools that facilitate using a single-point-of-entry approach to resolution in bankruptcy, perhaps in the form of a modified version of the chapter 14 proposal made by certain commentators,²² would facilitate the resolution of large financial firms. Such provisions should, in my view, include:

- Clarifying that bank holding companies can recapitalize their operating subsidiaries prior to the commencement of bankruptcy proceedings.
- Clarifying that section 363 of the Bankruptcy Code can be used to transfer recapitalized entities to a new holding company using a bridge structure of the kind I have described.
- Adding provisions that permit a short stay of close-outs and allow the assumption and preservation of qualified financial contracts, and overriding ipso facto (bankruptcy) defaults or cross-defaults that might impede the resolution process.
- Providing some form of fully secured liquidity resource that would offer financing to help stabilize the recapitalized firm and prevent fire sales until access to market liquidity returns.

²² See Thomas H. Jackson, *Bankruptcy Code Chapter 14: A Proposal*, in BANKRUPTCY NOT BAILOUT: A SPECIAL CHAPTER 14 (Hoover Institution, Kenneth E. Scott & John B. Taylor, eds., 2012). Professor Jackson recently disclosed that the Hoover Institution has been working on version 2.0 of its Chapter 14 proposal, which will include provisions specifically designed to facilitate a single-point-of-entry strategy under the Bankruptcy Code. See Remarks of Thomas H. Jackson, Panel on Resolution & Recovery – Bankruptcy Not Bailout, Annual Conference of The Clearing House Association (Nov. 21, 2013). See also BPC Report, pp. 11-14 (recommendations for amending the Bankruptcy Code to facilitate the execution of a single-point-of-entry strategy under the Bankruptcy Code).

Lastly I would note that no single resolution procedure will be perfect for all situations. Expanding the options available by continuing to develop resolution approaches under both OLA and the existing Bankruptcy Code, as well as considering amendments to facilitate resolution under the Bankruptcy Code, will maximize the flexibility to resolve distressed financial firms in a manner that minimizes systemic risk and does not put taxpayers at risk.

For these reasons, even if the Bankruptcy Code were amended to add tools to facilitate single-point-of-entry recapitalization in bankruptcy, I believe it is crucially important to retain Orderly Liquidation Authority as a back-up resolution option for large financial firms. Among other things, since we cannot know the causes or contours of the next crisis, we should want regulators to have a variety of sensible tools in their toolkit so they can use the right one when the time comes. In addition, key host-country regulators, who are less familiar with our bankruptcy system, will take comfort from the fact that if all else fails, United States regulators have the power to implement a recapitalization of distressed financial firms. Finally, as evidenced by the recent Moody's action, retaining OLA will also reinforce the idea that U.S. taxpayer money will never again be put at risk to support distressed financial firms.

I want to thank the Subcommittee for allowing me this opportunity to present my views. I would of course be delighted to answer any questions you may have about my testimony.